HSH ENGINEERING & CONSTRUCTION SDN BHD

v.

BELTON PROPERTIES SDN BHD & ANOR

HIGH COURT MALAYA, KUALA LUMPUR
RAMLY ALI JC
[SUIT NO: D9-24-258-2000]
16 MARCH 2001

CONTRACT: *Performance bond - Conditional or unconditional - Whether bank obliged to honour bond upon demand*

The plaintiff was the main contractor appointed by the 1st defendant for a development project on a certain piece of land. The plaintiff provided a performance bond in the form of a bank guarantee to the 1st defendant for the due performance of the contract between both parties. The performance bond was issued by the 2nd defendant bank in favour of the 1st defendant.

The plaintiff now applied for a perpetual injunction to restrain the 1st defendant from receiving payment under the performance bond and for an injunction to restrain the 2nd defendant from releasing monies to the 1st defendant pursuant to the 1st defendant's notice to call on the bond.

The 1st defendant submitted that the performance bond was an unconditional performance bond entitling the 1st defendant to call on the bond. The plaintiff submitted that the underlying contract between both parties had been terminated prior to the call on the bond. As such, the 1st defendant's claim on the bond was null and void. Further, the performance bond was a conditional performance bond which entitled the 1st defendant to call on the bond only upon the plaintiff's failure to observe the underlying contract between them. But the contract was terminated because the 1st defendant failed to settle the amount outstanding at that time.

Held:

[1] The relevant contents of the performance bond showed that it was an unconditional performance bond. All that was required to activate it was a written demand by the 1st defendant and the 1st defendant must also inform the 2nd defendant that it did so on the basis provided for in the performance bond itself. There was no necessity for the 1st defendant to prove any default by the plaintiff in performance of the underlying contract.

[2] The 2nd defendant was obliged to honour the performance bond according to its terms unless it had notice of clear fraud by the 1st defendant. The plaintiff's allegations that the 1st defendant's claim on the performance bond was made as a threat to the plaintiff and was *mala fide* and oppressive with the intention to create financial difficulties to the plaintiff were insufficient to establish the element of fraud.

[3] The dispute between the plaintiff and the 1st defendant on the underlying contract had nothing to do with the 2nd defendant and it did not affect the right of the 2nd defendant to make payment upon demand by the 1st defendant.

[4] There were no triable issues of the 1st defendant's claim on the performance bond. Therefore, on that ground alone the plaintiff was not entitled to the injunction. Also, the balance of convenience did not favour the granting of the injunction. That was because the 1st defendant would be unduly prejudiced by the perpetual injunction. Further, the issue of practical realities must be taken into consideration. Performance bonds of this nature are collateral to the underlying rights and obligations between commercial entities at either end of the banking chain. Except in clear cases of fraud, they must be allowed to be honoured free from interference by the courts.

[Application dismissed.]

Case(s) referred to:

China Air Lines Ltd v. Maltran Air Corpn Sdn Bhd (formally known as Maltran Air Services Corpn Sdn Bhd) & Anor [1996] 2 AMR 2233 ***(foll)***

Edward Owen Engineering Ltd v. Barclays Bank International Ltd [1978] QB 159 ***(foll)***

Esal (Commodities) Ltd & Anor v. Oriental Credit Ltd & Anor [1985] 2 Lloyd's Rep 546 ***(refd)***

Esso Petroleum Malaysia Inc v. Kago Petroleum Sdn Bhd [1995] 1 CLJ 283 ***(foll)***

Howe Richardson Scale Co Ltd v. Poh Mex-Cekop and National Westminster Bank Ltd [1978] 1 Lloyd's Rep 161 ***(refd)***

Intraco Ltd v. Notis Shipping Corporation [1981] 2 Lloyd's Rep 256 ***(refd)***

Keet Gerald Francis Noel John v. Mohd Noor Abdullah & Ors [1995] 1 CLJ 293 ***(refd)***

Kerajaan Malaysia v. South East Asia Insurance Bhd [2000] 3 CLJ 705 ***(foll)***

Kirames Sdn Bhd v. Federal Land Development Authority [1991] 2 CLJ 1366 ***(refd)***

Malaysia Overseas Investment Corporation Sdn Bhd v. Sri Segambut Supermarket Sdn Bhd [1986] 2 MLJ 382 ***(foll)***

Patel Holdings Sdn Bhd v. Estet Pekebun Kecil & Anor [1990] 2 CLJ 280 ***(foll)***

a *RD Harbottle (Merchantile) Ltd v. National Westminster Bank Ltd & Ors [1978] 1 QB 146* ***(foll)***
United Trading Corporation SA & Murray Clayton Ltd v. Allied Arab Bank Ltd & Ors [1985] 2 Lloyd's Rep 554 ***(foll)***

Legislation referred to:
b Companies Act 1965, s. 218
Specific Relief Act 1950, s. 51(2)

Other source(s) referred to:
Law on Banking, Pah Chu Chai, 1989, p 477

c *For the plaintiff - S Danaraj; M/s Hakem Arabi & Assoc*
For the 1st defendant - R Jegathesa; M/s RJ Esa & Co
For the 2nd defendant - YW Mak; M/s Yong & Mak

Reported by Usha Thiagarajah

d **JUDGMENT**

Ramly Ali JC:

Introduction

e By way of an originating summons dated 16 October 2000 (encl.1) supported by an affidavit-in-support (encl. 2), the plaintiff prayed for the following orders:

i) for a perpetual injunction restraining the 1st defendant from receiving payment under a performance bond from the 2nd defendant pursuant *f* to the 1st defendant's notice dated 29 May 2000;

ii) for an injunction to restrain the 2nd defendant from releasing the monies to the 1st defendant pursuant to the said notice of the 1st defendant to call on the bond;

g iii) for a declaration that the "call on the bond" arising from the said notice issued by the 1st defendant is unlawful.

Facts Of The Case

The facts leading to this action are as follows:

h On 26 August 1997, the plaintiff and the 1st defendant had entered into an agreement whereby the 1st defendant had appointed the plaintiff as the main contractor to develop a project known as "Cadangan Pembangunan Komersial dan Industri Ringan di atas Lot 181609 – 181622 di Jalan Kuala Kangsar, lpoh, Perak Darul Ridzuan" (hereinafter called "the said project") *i* involving a contract sum of RM19,553,063.30. However, as part of the

transaction, the plaintiff was required to provide a performance bond in the form of a bank guarantee to be executed by a financial institution in favour of the 1st defendant for the due performance of the agreement by the plaintiff. The 2nd defendant agreed to issue such performance bond. Consequently, a performance bond dated 7 August 1997 for a value of RM768,904.45 was issued by the 2nd defendant, (refer to Bank Guarantee for Performance Bond No: EON/KLG/BG970026, exhibited as "HSH-4" in encl. 2). The said performance bond was valid for a claim made "not later than 18 months after 2 December 1998".

Works on the said project, however, was not completed. The plaintiff claimed that the 1st defendant had failed to settle the amount due and outstanding as certified by the architect. The amount due from the 1st defendant to the plaintiff at the material time was RM945,295.48. The plaintiff then proceeded to terminate the contract (under cl. 26 of the said contract) *vide* a "Notice of Determination of Contract" dated 14 May 1998. The plaintiff then issued a notice under s. 218 of the Companies Act 1965 dated 29 April 1998. As there was no response from the 1st defendant, the plaintiff then filed in a winding-up petition, on 5 June 1998, against the 1st defendant. (The said winding-up petition was heard and dismissed on 16 February 2001 by the Kuala Lumpur High Court *vide* Winding-up Petition No: D2-28-391-1998).

On 29 May 2000 (ie, about four days before the expiry date the 18 months period stated in the said performance bond) the 1st defendant lodged its claim on the performance bond with the 2nd defendant on the same amount guaranteed therein ie, RM768,904.45. It is on this claim that the plaintiff is now applying for the orders in its originating summons (encl. 1).

Submission By The Plaintiff's Counsel

The plaintiff's counsel submitted that the claim on the performance bond made by the 1st defendant was null and void because it was made after the underlying contract was terminated on 29 April 1998. Thus all the obligations of the plaintiff under the said contract had also been terminated accordingly. It was also submitted that the said performance bond was a 'conditional performance bond' ie, on condition that the plaintiff had failed or defaulted to observe the terms of the underlying agreement dated 26 August 1997. In this case the plaintiff contended that there was no default on part of the plaintiff and the said agreement was terminated according to the terms of the agreement when the 1st defendant failed to settle the amount due and outstanding at that time. As such the plaintiff submitted that the condition to invoke the call of the said performance bond was not fulfilled.

Submission By The 1st Defendant's Counsel

The 1st defendant's counsel submitted that the said performance bond was an "unconditional on demand" performance bond on it's true construction. As such he contended that the notice of demand dated 29 May 2000, made within the validity period, (exh. "HSL-1" to encl. 2), was sufficient to trigger the claim made thereunder and that payment must be made by the 2nd defendant notwithstanding any contestation or protest by the plaintiff or by any other third party. The counsel partner submitted that the contractual obligations between the plaintiff and the 1st defendant, under the underlying agreement, are immaterial for the purpose of any claim made on the performance bond. Thus, the 1st defendant prayed that the plaintiff application in encl. 1 be dismissed with costs.

Findings Of The Court

The issue whether the said performance bond was a 'conditional' or an 'unconditional on demand' performance bond is material to determine whether there are any triable issues disclosed in this matter. In any application for an injunction, the court has to be satisfied first and foremost whether there are any triable issues disclosed. If there is no triable issue disclosed, the relief sought should be refused. If, on the other hand there are serious triable issues disclosed, then the court has to weigh the balance of justice or balance of convenience between the parties involved. This principle was clearly laid down by Gopal Sri Ram JCA, in delivering the judgment of the Court of Appeal in *Keet Gerald Francis Noel John v. Mohd. Noor bin Abdullah & Ors* [1995] 1 CLJ 293.

"Conditional" Or "Unconditional" Performance Bond

A performance bond or performance guarantee is a guarantee given by a bank or financial institution, on behalf of its customer that the customer will duly carry out the contract or agreement between the customer and a third party, who usually known as the beneficiary to the guarantee (see: *Kirames Sdn. Bhd. v. Federal Land Development Authority* [1991] 2 CLJ 1366 and Pah Chu Chai, *Law on Banking* (1989) at p. 477).

In *China Air Lines Limited v. Maltran Air Corporation Sdn. Bhd. (formally known as Maltran Air Services Corporation Sdn. Bhd.) and Anor* [1996] 2 AMR 2233, Mohamed Dzaiddin, FCJ (now CJ) had explained:

> A bank guarantee is a performance bond. There are two types of performance bond. The first type is a conditional bond whereby the guarantor becomes liable upon proof of a breach of the term of the principal contract by the principal and the beneficiary sustaining loss as result of such breach. The guarantor's liability will therefore arise as a result of the

principal's default. The second type is an unconditional or "on demand" performance bond which is so drafted that the guarantor will become liable merely when demand is made upon him by the beneficiary with no necessity for the beneficiary to prove any default by the principal in performance of the principal contract.

The same proposition was also quoted in another Federal Court's decision: *Kerajaan Malaysia v. South East Asia Insurance Bhd.* [2000] 3 CLJ 705.

The first issue that needs to be determined by the court in this case is whether the said performance bond is a 'conditional' or 'unconditional on demand' performance bond. In deciding this issue the court has to construe the relevant contents of the document itself. The material part of para. 1 of the said performance bond reads:

1. If the Contractor (unless relieved from the performance by any clause of the contract or by any statute or by the decision of a tribunal of competent jurisdiction) shall in any respect fail to execute the contract or commit any breach of his obligations thereunder then the Guarantor will indemnify the Principal the sum of Ringgit Malaysia: Seven Hundred Sixty Eight Thousand Nine Hundred Four & Cts. Forty Five Only (RM768,904.45) provided that the principal or his authorised representative has made a claim against the Guarantor not later than eighteen months (18) after 2nd December 1998.

The interpretation of the above clause in a performance bond is well-settled in view of the decisions of the Federal Court in *China Airlines Limited v. Maltran Air Corporation (supra); Kerajaan Malaysia v. South East Asia Insurance Bhd. (supra);* and *Esso Petroleum Malaysia Inc. v. Kago Petroleum Sdn. Bhd.* [1995] 1 CLJ 283.

In *China Airlines Limited*'s case, Mohamed Dzaiddin FCJ (now CJ), had said:

According to the learned authors of *"The Modern Contract of Guarantee,"* 2nd edn. p. 664, the tendency of the English Court (since, according to the authors, the Australian Courts have not yet been faced with the same problem of construction) has been to treat the performance bond as unconditional if there was a clear statement that the amount guaranteed was payable by the bank simply upon a written demand being made, eventhough there might be some indications to the contrary elsewhere in the document. The learned authors cited *Esal (Commodities) Ltd.*'s case, where the bank **"undertook to pay the said amount on your written demand in the event that the supplier fails to execute the contract in perfect performance,"** it was held that the later words (emphasis added) did not affect the fact that the money were payable upon a written demand being made as stated in the earlier part of the clause. The beneficiary of the bond did not have to show a failure to perform by the supplier in order to claim upon the bond.

In *China Airlines Ltd*'s case, the relevant undertaking clause is as follows:

> The said sum shall become payable by us in the event of the said MESSRS MALTRAN AIR CORPORATION SDN. BHD.'s failure to perform the said covenants.

In *Kerajaan Malaysia v. South East Asia Insurance Bhd. (supra)*, the relevant part of para. 2 of the guarantee reads:

> The guarantor shall pay damages to the Government a sum not exceeding RM420,645.00 within three months upon receipt of a written notice demanding the guarantor to pay the Government for any breach of the Contract's obligations under the contract ...

In both the cases, the Federal Court had adopted the approach taken by Lord Justice Ackner (as he was then) in *Esal (Commodities) Ltd. & Anor v. Oriental Credit Ltd. & Anor* [1985] 2 Lloyd's Rep 546, namely that the beneficiary of the performance bond must make a demand, and must also inform the bank that he does so on the basis provided for in the performance bond itself. In *Kerajaan Malaysia v. South East Asia Insurance Bhd (supra)*, the court had ruled that:

> There are three possible meanings which can be given to the above paragraph. First, no more than a mere written demand is required. Secondly, the demand must assert a failure to perform the contract. Thirdly, because of the word "damage", proof thereof and not mere assertion is required before liability under the bond aries. In our view, the second possibility is the answer because in addition to the demand made, the paragraph requires the Government to state the breach of the contractor's obligations under the contract.

In the instant case, the demand made by the 1st defendant for the said performance bond is contained in the letter dated 29 May 2000 (exh. "HSH-1"). The relevant paragraph of the said letter reads:

> The contractor has failed to execute the contract and committed breaches for his obligations under the said contract and the Contractor has not been relieved from the performance of any clause of the said contract or by any statute or by a decision of a tribunal of competent jurisdiction and in the circumstances you will indemnify us the sum of RINGGIT MALAYSIA SEVEN HUNDRED SIXTY EIGHT THOUSAND NINE HUNDRED FOUR AND CENTS FORTY FIVE ONLY (RM768,904.45) ONLY.

Therefore, from the above notice, the 1st defendant had fulfilled the necessary requirement and there is a clear assertion that the plaintiff had failed to execute the contract and committed breaches of its obligation under the said contract.

On the above authorities cited, I have no hesitation in concluding that the said performance bond dated 7 August 1997 issued by the 2nd defendant in favour of the 1st defendant is an "unconditional bond" or an "on demand bond" and all that is required to activate it is a written demand made by the 1st defendant and the 1st defendant must also inform the 2nd defendant, that he does so on the basis provided for in the performance bond itself. There is no necessity for the 1st defendant to prove any default by the plaintiff in performance of the underlying contract.

The Bank's Obligations Under A Performance Bond

In *Patel Holdings Sdn. Bhd. v. Estet Pekebun Kecil & Anor* [1990] 2 CLJ 280, the plaintiff had applied to the court for, *inter alia*, an injunction restraining the second defendant from making payment to the first defendant under a bank guarantee and to restrain the first defendant from receiving the same. Wan Adnan J (now CJM) dismissed the application on the ground that the guarantees were performance guarantees and the second defendant was obliged to honour them unless it has notice of clear fraud committed by the first defendant. The learned judge also held that:

> In order to prevent the second Defendant from honouring its obligation, the fraud must be on the performance guarantee itself, and not on any other document. The claim on the performance guarantee by the first Defendant must be fraudulent. The Plaintiffs make no such allegation and there is no evidence that the claim is fraudulent. I therefore find that there is no question to be tried. The Plaintiffs are not entitled to the injunction.

In *Edward Owen Engineering Ltd. v. Barclays Bank International Ltd.* [1978] QB 159, Lord Denning MR stated the law as to performance bonds as follows:

> All this lead to the conclusion that the performance guarantee stands on similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contractual obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or conditions. The only exception is when there is clear fraud of which the bank has notice.

In *United Trading Corporation SA & Murray Clayton Ltd. v. Allied Arab Bank Ltd. & Ors* [1985] 2 Lloyd's Rep 554, Lord Justice Ackner said:

Edward Owen Engineering [1978] Lloyd's Rep. 166; [1978] 1 QB 159, is of course the *locus classicus* for the proposition that a performance bond, standing on a similar footing to a letter of credit, obliges a bank to honour it according to its terms, unless it has notice of clear fraud committed by the beneficiary.

These leading authorities on performance bonds were followed by our courts. (see: *Malaysia Overseas Investment Corporation Sdn Bhd v. Sri Segambut Supermarket Sdn Bhd* [1986] 2 MLJ 382; *Patel Holdings Sdn Bhd v. Estet Pekebun Kecil & Anor (supra); Kiramas Sdn Bhd v. Federal Land Development Authority (supra);* and *Esso Petroleum Malaysia Inc. v. Kago Petroleum Sdn Bhd (supra).*

The same issue was also raised in the case of *Howe Richardson Scale Co. Ltd. v. Poh Mex-Cekop and National Westminster Bank Ltd.* [1978] 1 Lloyd's Rep 161, where the Court of Appeal held that:

> the obligation to pay did not depend on the correct solution of a dispute as to the sufficiency of performance by the seller to the buyer or the buyer to the seller as the case might be under the contract. It would be quite wrong for the court to interfere with Polimex's apparent right under the guarantee to seek payment from the bank, because to do so would involve putting upon the bank an obligation to enquire whether or not there had been timeous performance of the seller's obligation under the sale contract.

In that case, an injunction to restrain Polimex from claiming under a performance guarantee provided by National Westminster Bank Ltd. was not granted. The decision of that case was followed in *Intraco Ltd v. Notis Shipping Corporation* [1981] 2 Lloyd's Rep 256, as well as in our local cases of *Malaysian Overseas Investment Corporation (supra)* and *Kiramas Sdn Bhd (supra).* In *Malaysian Overseas Investment Corporation's* case, Siti Norma Yaacob J (now (FCJ) held that:

> On the facts of the case before me, the performance guarantee dated August 10, 1984, valid for one year and subject to renewal, is payable upon demand by the Defendants and as there is no allegation of any fraud, the Plaintiff cannot stand in the way of the Defendants realising the sum under the performance bond. Admittedly there is a dispute between them on the main contract but that has nothing to do with the Bank and as such does not affect the right of the Bank to make payment upon demand by the Defendants.

In our instant case, there is no allegation of fraud made by the plaintiff against the 1st defendant in making its claim under the said performance bond. In its affidavit (encl. 2) at paras 30 and 33, the plaintiff is alleging that the 1st defendant's claim on the performance bond was made as a

"threat" to the plaintiff and was "*male fide*" and "oppressive" ie, with the intention to create financial difficulty on the plaintiff. These allegations, if at all to be true, are insufficient to establish the element of fraud on part of the 1st defendant in making the claim.

Apparently, there are evidence to show that dispute existed between the plaintiff and the 1st defendant, particularly with regards to the terms of payment on the underlying contract, which led the plaintiff to terminate the said contract. Applying the rules applied in the cases cited earlier, I have no hesitation to hold that the dispute has nothing to do with the bank (2nd defendant) and it does not affect the right of the bank to make payment upon demand by the 1st defendant. All that is required to activate it is a written demand made by the 1st defendant stating, *inter alia*, that he does so on the basis provided for in the performance bond itself. There is, even no necessity for the 1st defendant to prove any default by the plaintiff in performance of it's obligations under the contracts. In this respect, I fully agree with Kerr J in *R.D Harbottle (Merchantile) Ltd. v. National Westminster Bank Ltd. & Ors* [1978] 1 QB 146, when he said:

> Only in exceptional cases that the courts will interfere with the machinery of the irrevocable obligations assumed by banks. They are the life-blood of international commerce. Such obligations are regarded as collateral to the underlying rights and obligations between the merchants at either end of the banking chain.
>
> Except possibly in the clear cases of fraud of which the banks have notice, the court will leave the merchants to settle their disputes under the contract by litigation or arbitration as available to them or stipulated in the contracts. The courts are not concerned with their difficulties to enforce their claims, these are risks which the merchants take. In this case, the Plaintiff took the risk of the unconditional wordings of the guarantees. The machinery and commitments of banks are on a different level. They must be allowed to be honoured free from interference by the courts. Otherwise, trust in international commerce would be irreparably damaged.

Thus in the above circumstances it is inappropriate for the court to issue injunction to restrain the bank (2nd defendant) to make payment on the performance bond as claimed by the 1st defendant. It is also inappropriate for the court to issue injunction to restrain the 1st defendant from making such claim or from receiving any payment on the performance bond. The effect is the same. Either way, the right of the bank (2nd defendant) to make payment and the right of the 1st defendant to realise the sum under the performance bond would be adversely affected. As has been said by Siti Norma Yaacob J (now FCJ) in *Malaysia Overseas Investment Corporation*'s case, "the plaintiff cannot stand in the way of the defendants realising the sum under the performance bond."

Triable Issues

Based on the above authorities and grounds, I therefore find that there is no issue or question that need to be tried on the issue of the 1st defendant's claim on the performance bond. Therefore, on this ground alone, the plaintiff is not entitled to the injunction as prayed in encl. 1.

Balance Of Convenience

In case, I am held to be wrong in coming to the above conclusion that there is no issue or question need to be tried, I will also consider the balance of convenience or the balance of justice in this case. In making this assessment, the court must take into account all relevant matters, including the practical realities of this case (see: *Keet Gerald Francis*'s case *(supra)*. In this case, the plaintiff is applying for a perpetual injunction, not an interim injunction. Under s. 51(2) of Specific Relief Act 1950, a perpetual injunction can only be granted by the decree made at the hearing and upon the merits of the suit. If injunction is granted, the 1st defendant would be perpetually deprived of the payment on the performance bond. The 1st defendant would be unduly prejudiced. That is the immediate effect suffered by the 1st defendant. On the other hand, if the injunction is not granted, the bank (2nd defendant) will be obliged to pay the amount claimed under the performance bond and as in all other cases involving performance bond, would seek to claim the monies so paid from the plaintiff. If that happened, the plaintiff may have to defend the claim or to recover the money by way of a civil suit either against the 1st defendant or the 2nd defendant. The effect on the plaintiff is not immediate.

The issue of practical realities must also be considered. The use of performance bond of this nature is the 'life-blood' of the modern commercial activities world-wide. They are regarded as collaterals to the underlying rights and obligations between commercial entities at either end of the banking chain. As stated in *R.D Harbottle*'s case *(supra)*, only in exceptional cases, possibly in the clear cases of fraud of which the banks have notice, that the court will interfere with the machinery of the irrevocable obligations by the banks. They must be allowed to be honoured free from interference by the courts. Otherwise trust in commercial activities, locally as well as internationally, would be irreparably damaged.

On the above considerations I am satisfied that the balance of justice in this case favours not to grant the injunction as prayed by the plaintiff.

Alternative Remedies

I am also satisfied that, in the event the plaintiff suffered losses as a result of the 2nd defendant releasing the money to the 1st defendant under the performance bond, the plaintiff would be adequately compensated by damages through a civil suit. In other words, there are alternative remedies available to the plaintiff, if at all it suffers damages. It is well-settled law that in cases where there are alternative remedies available, injunction is not an appropriate order to be granted.

Conclusion

For the above reasons, I therefore hold that this is not a proper case to grant the order of injuction as prayed under prayer 1 and 2 of encl. 1. As for prayer 3 of encl. 1, I have no hesitation to hold that the 1st defendant's notice dated 29 May 2000 to call on the performance bond was lawful and in accordance with the terms thereof. I therefore dismiss the application as per encl. 1, with costs.